How the IRS Reconstructs Income in Tax Fraud Cases

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Elements of Tax Evasion

- In all criminal cases, the government must prove each element of the offense beyond a reasonable doubt. There are three elements in a standard tax evasion case:
  - Substantial Tax Deficiency
  - Affirmative Attempt to Evade Tax
  - Willfulness

Substantial Tax Deficiency

- "Substantial" is a fact-specific inquiry that's left up to the jury, which must employ the everyday meaning of this word. The Third Circuit has also approved a definition of the term ("Whether the amount is 'substantial' turns on whether under the surrounding circumstances the amount of the deficiency would be significant to an ordinary person") that really isn't very useful.

Substantial Tax Deficiency

- If “substantial” means “more than noticeable,” we’re probably talking somewhere around 15 or 20 percent in additional taxes.

Affirmative Attempt to Evade Tax

- In an analysis borrowed from criminal conspiracy laws, the government must first prove that the taxpayer formulated an intention or scheme to evade the tax, and secondly, that the taxpayer committed at least one overt act in furtherance of that scheme.

Affirmative Attempt to Evade Tax

- The statute uses the term, “attempts.” Courts have added “affirmative” to the statute in order to emphasize the seriousness of the crime and to distinguish tax evasion from other less serious tax crimes.
- Example: A TP may intend to evade tax by failing to file his tax return.

Affirmative Attempt to Evade Tax

- However, a failure to do something alone is not an affirmative attempt to evade tax. There must be some other affirmative conduct to defeat the tax due and owing to support a tax evasion charge.
- This does not mean that the TP gets off scot free. He may be charged with the lesser offense of failure to file under section 7203, a misdemeanor.

Willfulness

- An elusive term
- While it may be easy to define – “an intentional violation of a known legal duty” – it is not easy to apply.
- TP does not have to be an evil, insidious person, nor must he have acted with an evil motive or in bad faith.

Willfulness

- All that is required is that the TP knew that he had a duty to pay the tax and knowingly intended to violate that duty.
- As courts have noted, “willful” is a “chameleon” which changes in tone and color according to the Internal Revenue Code section involved and the circumstances

FBAR Rule

A *U.S. person* must file an FBAR if that person has a *financial interest in or signature authority over* any *financial account(s)* outside of the United States and the *aggregate maximum value* of the account(s) exceeds $ 10,000 (USD) at any time during the calendar year.

Most Commonly Asked Questions About the FBAR

(1) How does an FBAR violation occur?

» An FBAR violation can occur in one of two ways:

- (1) first, by failing to disclose a foreign account on an FBAR altogether or

- (2) second, by disclosing a foreign account on an FBAR but underreporting the correct amount (i.e., the maximum value during the calendar year).

Willfulness

- How do courts interpret willfulness for FBAR violations?
  - The only thing that a person need know is that he has a reporting requirement. And if a person has that requisite knowledge, the only intent needed to constitute a willful violation of the requirement is a **conscious choice *not* to file the FBAR**.
  - The latter is referred to in legal circles as the theory of "willful blindness."

Willfulness

- What does it mean for a defendant to be willfully blind?
  - Under the theory of willful blindness, a jury may *infer* willfulness whenever a taxpayer intentionally fails to inquire and learn about his or her filing obligations.
  - In other words, instead of proving that the defendant intentionally violated a known legal duty, the government need only show that "the defendant consciously *avoided* any opportunity to learn what the tax consequences were." *United States v. Bussey*, 942 F.2d 1241, 1428 (8th Cir. 1992).

Willfulness - Criminal

- How does the government *prove* willfulness in the prosecution of a taxpayer for failing to file an FBAR?
  - Seldomly are there any witnesses and only in a rare case would a defendant admit the required state of mind.
  - So what does the government rely on? Indirect evidence. Specifically, conduct or acts from which a person's state of mind can be inferred. These acts are commonly referred to as "badges of fraud."

Badges of Fraud

- Examples of some common "badges of fraud" that are sure to attract the IRS's attention:
  - A taxpayer who checks the box off "no" on Schedule B in response to the question, "Do you have an interest in or signature authority over a financial account in a foreign country?" when, in fact, he has just such an account.
  - Whether the failure to report the account occurred *continuously* over a period of years or whether it was merely an *isolated* incident. In other words, did the taxpayer's failure to file an FBAR occur over the course of time or just one year?

Badges of Fraud

- Whether the taxpayer failed to report a foreign account in a later year despite having checked the box off "yes" on Schedule B of his tax return in an earlier year (and/or filing an FBAR in an earlier year). This reveals that the taxpayer *knew* that he had an FBAR-reporting obligation in the later year.

- The high watermark balance of the account: The amount of money at stake is crucial. Unreported accounts with maximum aggregate balances that are half-a-million or greater are heavily scrutinized. As one prominent tax attorney has been quoted as saying, "If a person has a $10 million account, I don't want to hear he was nonwillful, and neither does the government."

Badges of Fraud

- Whether the taxpayer told his tax preparer about the account(s).
- Whether the account was held in such a way as to *conceal* ownership.

  - For example, was it in the name of a "foreign shell corporation or foreign trust," or some other entity that would make it difficult for the IRS to learn the true identity of the owner?

  - Was the account a numbered account?
  - Was the taxpayer issued a credit or debit card without his or her name visible on the card itself?

Badges of Fraud

- Did the bank help the taxpayer repatriate cash to the U.S. using covert means?
  - Did bank managers and their U.S. clients use code words in emails to gain access to funds?
  - Did U.S. clients ever use coded language, such as asking their private bankers, “can you download some *tunes* for us?” or note that their “gas tank [was] running empty” when they required additional cash to be loaded to their cards.

Badges of Fraud

- Whether the taxpayer closed the foreign account and transferred the assets to another bank in the wake of a DOJ press release or media coverage reporting that the taxpayer's bank had become the target of an IRS summons demanding U.S. accountholder information or that it had agreed to participate in FATCA. Example: Headlines splashed across the front page of major newspapers.

- Whether a taxpayer who has a duty to file an FBAR checks the box off "yes" to the question, "Do you have an interest in or signature authority over a financial account in a foreign country?" but "no" to the follow-up question, "If 'Yes,' are you required to file Form TD F 90-22.1 [FBAR] to report that financial interest or signature authority?" This question gets to the heart of the matter: "Must an FBAR be filed?"

Badges of Fraud

- The amount of interest generated by the foreign account and whether that interest – no matter how negligible – was reported on the taxpayer's U.S. tax return. If the interest was reported on a U.S. tax return, the IRS generally views the filing of an FBAR as a mere formality. In that case, the taxpayer can usually come into compliance with his U.S. tax obligations by filing a delinquent FBAR.

- Whether the taxpayer instructed bank personnel to hold back his bank statements and not mail them to him in the U.S. (if the U.S. residence was listed as the accountholder's primary residence).

Badges of Fraud

- Whether the taxpayer had been subject to a previous audit involving unreported offshore assets or bank accounts.

- The number of foreign accounts held (i.e., one versus six).

Badges of Fraud

No single factor is dispositive. It is a *totality of the circumstances* test.

Badges of Fraud

- Ultimately, the jury must “look into the mind of the defendant-taxpayer to determine whether he intentionally violated the statute.”
- To the extent that the government can show the jury enough “badges of fraud” to prove willfulness beyond a reasonable doubt, the government will have satisfied its burden of proving criminal intent through circumstantial evidence.

Burden & Standard of Proof

- In civil cases, the burden of proof is on the TP
- In the criminal realm, the government bears the burden of proof. And the standard of proof is “beyond a reasonable doubt”

Burden & Standard of Proof

- What does beyond a reasonable doubt mean? A doubt based upon reason and common sense after careful and impartial consideration of all the evidence. It is proof of such a convincing character that jurors would be willing to rely upon it w/o hesitation in the most important of their *own* affairs

Burden & Standard of Proof

- As for reasonable doubt, the Third Circuit has approved the following instruction: “A reasonable doubt is not a caprice or whim; it is not a speculation or suspicion. It is not an excuse to avoid the performance of an unpleasant duty. And it is not sympathy.”

Burden & Standard of Proof

- Two aspects of the burden of proof – (1) risk of nonpersuasion (i.e., burden of persuasion) or (2) burden of production. It's important to distinguish between the two as the distinction impacts the outcome of cases.

Burden & Standard of Proof

- Risk of non-persuasion does not shift. It starts out on the government and it remains on the government.
- The burden of production can shift with respect to particular issues in the case.

Shifting Burden of Production

- The overall burden of persuasion never moves away from the government, but the burden of production sometimes shifts.
- Initially, the government has the burden of production as well, because there must be sufficient evidence to convince a reasonable juror that the defendant is guilty.

Shifting Burden of Production

- This shift occurs in income reconstruction cases.

Shifting Burden of Production

- Example: In a 7201 evasion of assessment case, the government shows that Adam *omitted* $ 100K of taxable receipts from his return.
- Issue: Does this prove beyond a reasonable doubt that Adam owed tax on an additional $ 100K of income and thus committed tax evasion?

Shifting Burden of Production

- By itself, this is insufficient to prove that there was additional tax due and owing. Why? It is theoretically possible that Adam had unreported deductible expenses that either *completely* offset the omitted income or offset it enough that the resulting tax was no longer *material* and therefore was *insufficient* to sustain a tax evasion charge

Shifting Burden of Production

- Rule: The *mere* proof of unreported income is insufficient to establish additional tax liability

Shifting Burden of Production

- What if Adam remains silent and doesn't suggest additional deductions or credits? Must the government go out and investigate every possible deduction? The IRC contains hundreds of deductions and credits.

Shifting Burden of Production

- Does the government have to say, “We investigated whether there is a child credit and there is no child credit available here. We investigated whether Adam had more medical and dental deductions than were claimed on the return but there are no S 213 deductions. And we looked at Adam’s business and didn’t find any accelerated appreciation deductions under 168.”

Shifting Burden of Production

- In other words, must the government negate every possible additional deduction or credit? No. It is n/ part of the government's burden of production to negate every deduction.

Shifting Burden of Production

- Instead, once the government shows that there is unreported income, the burden of production *shifts* to the defendant to identify additional, offsetting deductions.
- The TP-defendant must indicate at least *some basis* for believing that these deductions exist.

Shifting Burden of Production

- In other words, assuming Adam can produce evidence that he had expenses and deductions which reduced the tax to the point that it was no longer “substantial,” the government’s case must fail, unless it can refute Adam’s version of events.

Shifting Burden of Production

- Assume that Adam has some basis for believing that additional, offsetting deductions exist. In that case, the burden would shift back to the government to *negate the asserted additional deductions*. Ultimately, it's up to the jury to decide who made the more convincing case.

Shifting Burden of Production

- Summary: The risk of non-persuasion starts out on the government and ends on the government. The burden of going forward starts on the government, may shift to the defendant, and then may shift back to the prosecution. Theoretically, there could be further shifts.

Direct, Indirect, & Hybrid Methods of Proof

- This section addresses the means or theories by which the government attempts to prove the “tax due and owing” element of Section 7201, tax evasion

Direct, Indirect, & Hybrid Methods of Proof

- These methods may be used *either* during the government's case-in-chief or at sentencing. Under the sentencing guidelines, the most important consideration is the *amount* of tax loss. The *larger* the tax loss, the *greater* the period of incarceration for the convicted defendant.

Direct, Indirect, & Hybrid Methods of Proof

- As unsettling as it might be, the government can attempt to prove for sentencing purposes a *larger* amount of tax liability than it attempted to prove at the guilt or innocence stage (i.e., at trial)

Direct Method

- Prosecutors can use the *direct method* to either establish unreported income or, in a few other cases, to refute taxpayers' claims regarding expenses and deductions.

Direct Method

- Scenarios
  - In scenario number one, the government asserts: “It’s right here. We can point to exactly what the problem is on this return. This deduction was claimed at $ 40K but it is legitimately only a $ 5K item. We can prove a $ 35K overstatement of deductions.”

Direct Method

- In scenario number two, TP got $ 75K worth of receipts from person “A”. These receipts were taxable but TP never reported them on his tax return. IRS’s argument: “We can identify precisely where it is on the false return and how it gave rise to the additional tax liability due and owing.”

Direct Method

- Typically, the government compares the claimed or reported amount on the tax form to the *actual* receipt, and *ipso facto*, it effectively meets both the burden of production and the burden of persuasion, because it is almost impossible for a defendant to explain away direct proof of this type.

Direct Method

- In other cases, these receipts can “fill in the blanks” in an allegedly fraudulent return.

Direct Method

The government greatly prefers direct methods to indirect methods!

Direct Method

- It always starts with the taxpayer's return. When TP has filed a return for the year in question, the government will introduce it. In doing so, the IRS will use the taxpayer's admitted income as a baseline.

Direct Method

- For hearsay purposes, the return is deemed TP's admission as to the items included on the return. Therefore, it's admissible.

Direct Method

- Example # 1: If the return reflects $ 40K of gross income, the government can treat that amount as a given. Def. may later state, “Oops, I was wrong. I didn’t have $ 40K, only $ 30K.” But that is a tough road to hoe b/c TPs don’t typically overstate their income on returns.

Direct Method

- Example # 2: If TP wants to *dispute* additional unreported income by asserting *additional* deductions, the fact that these additional deductions weren't on the return constitutes an *admission* that there weren't any additional deductions.

Direct Method

- Criminal numbers, sentencing numbers, and civil numbers
  - Typically, these three numbers *diverge*. The government will be the most conservative where it has the *highest burden of proof (i.e., beyond a reasonable doubt)*
  - Therefore, it's not unusual for the government to use different amounts during the guilt/innocence and sentencing phases.

Direct Method

- Trial: There might be more unreported income than what the government asserts in the guilt or innocence phase of the trial. For example, the government might believe that there is $ 110K of unreported income but $ 30K of that could go either way. Why? Very simply, there might not be enough evidence to prove evasion of $ 30K. In that case, the government will assert only $ 80K during the guilt or innocence phase.

Direct Method

- The government typically introduces rock solid, hard, unshakable evidence in the guilt or innocence stage. Why? B/c if there is a rumbling or shaking, this tends to introduce reasonable doubt. For this reason, the government usually selects a *smaller number* at the guilt or innocence stage.

Direct Method

- At the sentencing stage, the government goes for more – i.e., the additional $ 30K
- On the civil side, the government seeks the *maximum*

Direct Method

- To return to our friend Adam, the Service might only establish $75,000 in unreported income during guilt/innocence, because the evidence regarding the other $25,000 is a little shaky.
- Later, at the penalty (sentencing) phase, prosecutors can use the $100,000 amount to maximize the criminal penalties against poor Adam.

Indirect Methods

- In all criminal cases, if there is no “smoking gun,” the prosecutor must rely on circumstantial evidence.
- The government may argue that there is circumstantial evidence which logically leads to the inescapable conclusion that TP’s return is *wrong*, even though the government can’t point to *exactly* what it is.

Indirect Methods

- Subject to *heightened* scrutiny
  - Complicated and difficult to explain to juries. B/c of their potential for mischief, appellate courts closely scrutinize indirect methods. Therefore, the chance of reversal on appeal is great.

Indirect Methods

- There is a multi-step process. The government must establish the following:
  - (1) A direct method is n/ available or is unreliable, and
    - Not available: TP's books and records are unavailable (e.g., TP *never* kept them or *lost* or *destroyed* them)
    - Unreliable: TP's books and records are available but they are n/ reliable (e.g., they contain errors galore)

Indirect Methods

- This barrier prevents prosecutors from ignoring hard evidence that may not be as damning in favor of “circumstantial” evidence that artful lawyers can doctor up.

Indirect Methods

- (2) A likely taxable source for the unreported income
  - Government must show some source from which TP was likely to have gotten the unreported income.
  - For example, Adam may have reported $100,000 of income from a consulting company in 2015 and zippo in 2016.

Indirect Methods

- If the judge determines that the prosecutors met both elements of the preliminary test and therefore may use indirect evidence, there are five approved models:

Indirect Methods

- Types of *indirect* methods:
  - Net worth method
  - Expenditures method
  - Bank deposits and cash expenditures method
  - Percentage mark-up method
  - Indirect methods to prove overstated deductions

Net Worth Method

- Attempts to demonstrate that TP had *more* taxable income than what was reported.
- How? By showing that TP had an *increase* in his net worth – an increase that could only have come from taxable income

Net Worth Method

- The government establishes its case through the net worth method in the following steps:
  - The government establishes defendant's opening net worth using *cost basis*. Typically, these are multiple tax years. The government shows, *at the beginning of the first prosecution year*, the defendant's *net worth*. Net worth must be calculated for non-cash assets at *cost basis*, n/ FMV. If TP's asset appreciates in value *before* a realizable event – such as the sale of the assets – TP does n/ have income. An unrealized appreciation is n/ taxable income

Net Worth Method

- The government shows increases in net worth *at the end* of each of the years for the prosecution period
- The government subtracts any known non-taxable receipts. Increase in net worth and any acquisition of new assets may have been financed by income that wasn't taxable
- The government must prove willfulness, directly or by inference

Net Worth Method

- Reasons why government prefers to use the direct method over the net worth method:
  - Appellate courts are *suspicious* of indirect methods and will allow their use *only* if the government has *no other recourse* and only if the method is applied *strictly*
  - There aren't as many IRS agents who are skillful in applying the indirect methods

Net Worth Method Defenses

- What are some common *defenses* to net worth cases?
  - (1) The net worth increase shown by the government is n/ an increase at all b/c of the existence of substantial cash on hand *at the starting point*
  - (2) The net worth increase is attributable to some *nontaxable* source
  - (3) Attacking the *accuracy* of the government's opening or closing net worth figure

Net Worth Method Defenses

- (1) The net worth increase shown by the government is n/ an increase at all b/c of the existence of substantial cash on hand *at the starting point*
  - Defendant must testify: "I had a cash hoard which I had *built up* over pre-prosecution years and which I did *n/* spend *until* the prosecution period. That's what supports the increase in my net worth. I used the money from this cash hoard to buy these additional assets, n/ from unreported taxable income"

Net Worth Method Defenses

- Cash hoards are usually hidden inside underground PVC pipes in the backyard or inside mattresses
- What are the potential *sources* of a cash hoard?
  - Nontaxable sources, or
  - Taxable sources in years as to which the SOL has already expired

Rebutting Cash Hoard Defense

- How does the government *rebut* the cash hoard defense?
  - Government must prove a *negative* – i.e., that there was *no* cash hoard
  - Admissions made by TP
  - Financial statements given by TP to federal or state agencies (or banks)

Rebutting Cash Hoard Defense

- Reconstructing TP's income from pre-prosecution years using tax returns and other information to show *low* amounts of prior income
  - If there isn't a lot of income listed on prior year returns, the government can legitimately ask, "Where did the money come from?" Maybe the answer is, "nontaxable sources." But TP nonetheless has to identify who died and left him money

Rebutting Cash Hoard Defense

- Establishing a history that casts *doubt* on the idea that TP had cash lying around, such as TP filing *bankruptcy* or *borrowing money* (i.e., TP files a loan application)

Rebutting Cash Hoard Defense

- Example: Does TP have significant balances on his credit cards? If so, why? If TP had cash lying around, why didn't he use that cash to pay off the credit cards to avoid the 22% interest rate?
- Example: Why did TP have to file bankruptcy if he had all of this cash lying around?
- Example: Why did TP have to *borrow* money if he had all of this cash lying around?
- Example: Why was TP living below the poverty level and/or why did TP file a low income housing application?

Net Worth Method Defenses

- (2) The net worth increase is attributable to some *nontaxable* source
  - Gifts, inheritances, and loans might account for the newly-acquired wealth. These items are non-taxable
  - Examples: My aunt died and left me $ 100K. My brother gave me $ 10K. I got a loan.

Net Worth Method Defenses

- Government has no burden to negate this defense *until TP puts its into play*
- How much detail must the defense give the government and when? Need to give government this information w/ sufficient specificity and w/ sufficient timeliness. If the defense fails to do either, then the government is relieved of its obligation to negate the item

Net Worth Method Defenses

- Example
  - An IRS investigation showed that TP had an opening year net worth of $ 50K. TP had a checking account w/ $ 50K which was the *only* asset the IRS could locate. The net worth method conclusively proved that TP had *$ 57K of unreported income* in the two-year period

Net Worth Method Defenses

- TP's argument: The method is flawed b/c I had an opening net worth in the form of an *inheritance* that the IRS did n/ identify or verify

Net Worth Method Defenses

- One month *before* the opening date of the two-year period, TP received a $ 50K inheritance that was non-taxable. He went to Las Vegas, cashed it there, and lost it all within days. Had TP retained the $ 50K past "*day one*" of the two-year period, it might have accounted for enough of the indicated income that *the government would n/ have pursued an evasion case on the $ 7K that remained*. But b/c the cash had been spent *prior* to "day one" of the two-year period, the net worth method *correctly* indicated that TP had $ 57K of unreported income.

Net Worth Method Defenses

- Issue: Assume that the IRS could *not* exclude the possibility that TP held *all* of the cash on the critical opening date. Can TP's attorney *affirmatively* advise the IRS that the inheritance accounts for $ 50K otherwise unaccounted-for cash on the opening date?
- Relevance: Eliminates the net worth method as a means to obtain a conviction

Net Worth Method Defenses

- Answer: Can't say to government: "Your figures are wrong b/c you did n/ include this $ 50K inheritance." Why? Misrepresenting a known false fact violates 1001. But the attorney could ask the IRS Special Agent *if he considered the inheritance just one month before*. It's a suggestion, n/ a statement. By asking this question, the attorney merely *implies* that the money *might* account for some significant part of the otherwise indicated unreported income.

Net Worth Method Defenses

- Is that implication sufficiently close to a statement that defense counsel still has an ethical problem or 1001 problem?
- Rationale: The defense has the right, at trial, to challenge the methodology used by the government to identify *opening net worth*. Therefore, defense counsel should be able to ask the agent whether a significant item that *should* have been considered, but wasn't, could impact the government's application of the net worth methodology

Net Worth Method Defenses

- (3) Attacking the *accuracy* of the government's opening or closing net worth figure
  - This argument is just straight-up "you crunched the numbers wrong."
  - Example: "The opening net worth that I had was *greater* than you thought it was. Therefore, the difference between opening and closing net worth was *less*." Or, "The closing net worth was *less* than what the government thought it was."

Pitfalls Inherent in Net Worth Method

- While the government may be able to prove w/ reasonable accuracy an increase in net worth over a period of *years*, it often has great difficulty in relating that income sufficiently to any *specific* prosecution year. That's why the government seldomly brings a *single-year* indirect method case

Pitfalls Inherent in Net Worth Method

- In recognizing the potential inaccuracies of this approach, what should courts do?
  - Judges should approach these cases w/ the realization that these imprecise methods might ensnare innocent taxpayers in the coils of prosecution
  - Jury charges should be crystal clear, including a summary of the nature of the net worth method, the assumptions on which it rests, and inferences available both for and against the accused

Pitfalls Inherent in Net Worth Method

- Appellate courts should be particularly vigilant to make sure that the trial judge did his job and that there wasn't an inappropriate conviction based on a faulty use of an indirect method

Expenditures Method

- AKA “source and application of funds” method
- If the taxpayer “wasted his substance with riotous living (to borrow a phrase from the story of the prodigal son),” the Service cannot use the net worth method, and must convince the jury that the taxpayer spent so much money that there must have been an additional income somewhere.

Expenditures Method

- Difference
  - If TP uses additional unreported income to acquire *assets*, then the net worth method applies
  - But what if TP doesn't acquire assets but instead *spends it* on high living, n/ involving any fixed or portable assets. In that case, the government employs the *expenditures method*

Expenditures Method

- The government establishes opening and closing net worth (i.e., needs to show that expenditures did n/ come from drawing down previous assets)
- Government must show the *amount* of expenditures made by TP during the year
- Government also has to deal w/ non-taxable sources

Expenditures Method

- *Taglianetti v. U.S.*
  - Defendant's argument: "Government failed to establish opening and closing net worth figures w/ accuracy"
  - The First Circuit held that the IRS must only establish an opening and closing net worth with reasonable certainty.

Expenditures Method

- Analysis: Although the amount may n/ have been established w/ precision, what was established was that the net worth at both the *beginning* and at the *end* of the prosecution was *about the same*. As long as there wasn't a decrease, then the expenditures could n/ have been funded by drawing down previous assets
- Opening and closing net worth is significant in a comparative or a relative sense, but n/ in an absolute sense

Bank Deposits & Cash Expenditures Method

- This is a hybrid method b/c it involves two different methods that have been rolled together into one – it basically combines the first two.
- It assumes that deposits into the defendant's bank account and expenditures made by Def. are taxable income *unless* they came from a nontaxable source

Bank Deposits & Cash Expenditures Method

- Two chief advantages to using this method:
  - The government need n/ establish opening and closing net worth.
  - The government need only produce sufficient evidence for a reasonable juror to find fraud, as opposed to any of the classic fraud badges (*e.g.* hidden accounts or duplicate books).

Bank Deposits & Cash Expenditures Method

- Application of hybrid approach (*U.S. v. Esser*)
  - Facts: Three tax years were in question. The government charged defendant under S 7201. In bank deposit cases, it's customary for the government to introduce deposit slips. However, in this case, it was virtually impossible to introduce deposit slips due to their poor quality, unreliability, and unavailability. Instead, the government introduced bank statements and pass books as the most reliable evidence available

Bank Deposits & Cash Expenditures Method

- Defendant's first argument: The bank deposits theory requires an analysis of bank deposit items themselves. The government had a duty to specifically *identify* and *analyze* the defendant's deposit slips. The failure to do so is fatal to the government's case
- Held: No. This is a jury question. It's up to the jury to decide whether there was satisfactory proof of deposits. There is no one legally required method. If the jury thinks that it's sufficient, that's good enough

Bank Deposits & Cash Expenditures Method

- Defendant's second argument: The government failed to prove willfulness
- Held: No. Willfulness can be *inferred* by the jury as long as there is a satisfactory evidentiary basis for the inference

Bank Deposits & Cash Expenditures Method

- Reasoning: Admittedly, there was no evidence of the classic badges of fraud, e.g., duplicate books and hidden accounts. However, the government presented sufficient evidence to allow the jury to find that def. engaged in a pattern of *understating* income for *three consecutive years*. That was sufficient to give the jury the right to *infer* willfulness

Percentage Mark-Up Method

- Much more common in civil cases than in criminal cases.
- In criminal cases, it is n/ the *principal* method of proof! Instead, it corroborates understatements established by more reliable techniques

Percentage Mark-Up Method

- This method is used when TP is in a trade or business. The IRS sometimes takes the inventory and multiplies it by a predetermined profit margin to arrive at an unreported income figure. The profit percentage may come from general industry averages.

Percentage Mark-Up Method

- There are a lot of holes in this method, not the least of which is that item markup varies greatly under different circumstances, so the Service normally only uses this method in civil court, where there is a lower burden of proof.

Percentage Mark-Up Method

- Potential def. arguments:
  - “My business does worse than the average. The fact that the industry has an average 16% profit doesn’t mean that I have a 16% profit.”
  - “I deal in several different kinds of products and there are different profit percentages on these different kinds of products. This means complex calculations!”

Percentage Mark-Up Method

- What if the percentage changes? TP sells a number of different products but in varying percentages over the years

Percentage Mark-Up Method

- When TPs underreport income, they often *underreport their deductions* for cost of goods sold. That is, they understate the amount that they *actually* spent on inventory. By doing so, that gives the impression that they had *less* inventory and less merchandise. Therefore, they sold less and had less income. By understating deductions, that covers up a bigger understatement of income
- Note: The understatement of inventory is itself an affirmative act!

Indirect Methods to Prove Overstated Deductions

- The main use of indirect methods is to establish underreported income. On rare occasions, indirect methods can be used to establish *overstated deductions*
- In something of a reverse net-worth argument, the IRS may try to prove that the taxpayer didn't have enough income to claim certain deductions; this method assumes that the taxpayer didn't have any leftover money from previous years, and that's often a tenuous assumption.

Indirect Methods to Prove Overstated Deductions

- Government's argument: TP overclaimed deductions for employee business expenses on the return

Indirect Methods to Prove Overstated Deductions

- As a preliminary matter, it's hard for the government to prove an overstatement of deductions. In the criminal context, if TP's return says that he spent $ 40K on deductible items, the government *must* show that $ 40K *wasn't spent on deductible items*.
- How does the government do that? Does the government ask everyone that TP has ever done business with, "How much did TP pay you and for what?"

Indirect Methods to Prove Overstated Deductions

- In this case, the government argued that TP did n/ have enough income to make the expenditures that he claimed to have made. Therefore, the deductions *must* have been *overstated*. This is a *reverse* net worth method argument.
- After the government presents its case in chief, it's customary for the defense to move for an acquittal on the grounds of insufficiency of evidence. The defense did just that and the court granted the motion and dismissed the case!

Indirect Methods to Prove Overstated Deductions

- Analysis: The government's proof consisted of nothing more than that TP didn't have any money generated by the activity in the year in question. That doesn't establish whether TP had money generated by previous years' activities *outside* of the prosecution period

Appellate Review

- When an appellate court reviews the sufficiency of evidence, it does so in the light most favorable to the party for whom the jury gave its verdict. If Def. is *convicted*, questions of evidentiary sufficiency are evaluated in a light that is most favorable to *upholding* the conviction. Having expended the judicial resources, courts don't want to undue the verdict and try the case a second time

Appellate Review

- In other words, if the jury convicts the taxpayer, the taxpayer must prove on appeal that the evidence was almost laughably inadequate and no reasonable juror could have possibly voted to convict based on such proof.

Defense Strategy in Indirect Method Cases

- Providing the IRS w/ leads or hints of leads can potentially set the stage for attack on the basis that the agents *passed up* reasonable leads. Of course, the lead must suggest some potential *relief* to the target so that it is fair to reject the methodology for failure to pursue the lead

Hybrid Methods

- Various indirect methods can be combined in hybrid kinds of approaches as long as that does n/ create confusion.

Closing Remarks

- Anyone who has ever faced off against the IRS knows all too well that this agency has a number of tools to collect what it claims the taxpayer owes, and in an audit situation, these tools are powerful and intimidating. They are still present in criminal court, even if there is no direct evidence supporting an income tax evasion claim.

Closing Remarks

- Nonetheless, the harder DOJ-Tax must work to obtain a conviction, the higher the likelihood of a positive outcome for the taxpayer.